

COMMONWEALTH INSURANCE COMPANY, INC.

FINANCIAL STATEMENTS

Years Ended June 30, 2018 and 2017

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Independent Auditors' Report

To the Stockholder
Commonwealth Insurance Company, Inc.
Frankfort, Kentucky

We have audited the accompanying financial statements of Commonwealth Insurance Company, Inc. (a Kentucky corporation), which comprise the balance sheets as of June 30, 2018 and 2017, and the related statements of income and comprehensive income, stockholder's equity, and cash flows for the years then ended, and the related notes to the financial statements.

Management's Responsibility for the Financial Statements

Management is responsible for the preparation and fair presentation of these financial statements in accordance with accounting principles generally accepted in the United States of America; this includes the design, implementation, and maintenance of internal control relevant to the preparation and fair presentation of financial statements that are free from material misstatement, whether due to fraud or error.

Auditors' Responsibility

Our responsibility is to express an opinion on these financial statements based on our audits. We conducted our audits in accordance with auditing standards generally accepted in the United States of America. Those standards require that we plan and perform the audits to obtain reasonable assurance about whether the financial statements are free from material misstatement.

An audit involves performing procedures to obtain audit evidence about the amounts and disclosures in the financial statements. The procedures selected depend on the auditors' judgment, including the assessment of the risks of material misstatement of the financial statements, whether due to fraud or error. In making those risk assessments, the auditor considers internal control relevant to the entity's preparation and fair presentation of the financial statements in order to design audit procedures that are appropriate in the circumstances, but not for the purpose of expressing an opinion on the effectiveness of the entity's internal control. Accordingly, we express no such opinion. An audit also includes evaluating the appropriateness of accounting policies used and the reasonableness of significant accounting estimates made by management, as well as evaluating the overall presentation of the financial statements.

We believe that the audit evidence we have obtained is sufficient and appropriate to provide a basis for our audit opinion.

Basis for Qualified Opinion

Commonwealth Insurance Company, Inc.'s financial statements do not include disclosures required by accounting standard No. 2015-09, Financial Services – Insurance: Disclosures about Short-Duration Contracts, issued by the Financial Accounting Standards Board. In our opinion, these disclosures are required to conform with accounting principles generally accepted in the United States of America; however, management has received permission from the Kentucky Department of Insurance to exclude such disclosures.

Qualified Opinion

In our opinion, except for the effect of the matter discussed in Basis for Qualified Opinion paragraph, the financial statements referred to above present fairly, in all material respects, the financial position of Commonwealth Insurance Company, Inc. as of June 30, 2018 and 2017 and the results of its operations and its cash flows for the years then ended in accordance with accounting principles generally accepted in the United States of America.

Deming, Malone, Lussary & Ostroff

Louisville, Kentucky
October 15, 2018

COMMONWEALTH INSURANCE COMPANY, INC.

BALANCE SHEETS
June 30, 2018 and 2017

Assets	2018	2017
Cash and cash equivalents	\$ 381,794	\$ 496,139
Investments	7,627,568	7,073,367
Other assets	48,063	44,117
Total assets	\$ 8,057,425	\$ 7,613,623
Liabilities and Stockholder's Equity		
Estimated liability for future claims, net of estimated recoveries:		
Reported claims	\$ 138,000	\$ 138,000
Claims incurred but not reported	392,000	452,000
	530,000	590,000
Accounts payable	5,402	4,970
Income taxes payable	9,872	18,618
Deferred income tax	23,000	74,000
	38,274	97,588
Total liabilities	568,274	687,588
Stockholder's Equity		
Common stock, no par value; authorized 1,000 shares; issued and outstanding, 600 shares	1,500,000	1,500,000
Retained earnings	5,904,709	5,266,958
Accumulated other comprehensive income	84,442	159,077
	7,489,151	6,926,035
Total liabilities and stockholder's equity	\$ 8,057,425	\$ 7,613,623

See Notes to Financial Statements.

COMMONWEALTH INSURANCE COMPANY, INC.

STATEMENTS OF INCOME AND COMPREHENSIVE INCOME

Years Ended June 30, 2018 and 2017

	2018	2017
Revenues		
Premium revenue	\$ 950,000	\$ 950,000
Investment income	189,294	153,099
Realized gains on investments	147,319	102,481
Total revenues	1,286,613	1,205,580
Expenses		
Claims expense and change in estimated liability for future claims	106,804	(5,000)
Office and administrative fees	151,655	149,263
Professional fees	57,506	41,633
Management fee	256,000	249,300
Provision for income taxes	76,897	59,630
Total expenses	648,862	494,826
Net income	637,751	710,754
Other Comprehensive Income		
Unrealized gain on investments, net of tax	72,684	104,920
Reclassification adjustment for realized gains	(147,319)	(102,481)
	(74,635)	2,439
Total comprehensive income	\$ 563,116	\$ 713,193

See Notes to Financial Statements.

COMMONWEALTH INSURANCE COMPANY, INC.

STATEMENTS OF STOCKHOLDER'S EQUITY

Years Ended June 30, 2018 and 2017

	Common Stock	Retained Earnings	Accumulated Other Comprehensive Income (Loss)	Total
Balances, June 30, 2016	\$ 1,500,000	\$ 4,556,204	\$ 156,638	\$ 6,212,842
Net income		710,754		710,754
Other comprehensive income, net			2,439	2,439
Balances, June 30, 2017	1,500,000	5,266,958	159,077	6,926,035
Net income		637,751		637,751
Other comprehensive loss, net			(74,635)	(74,635)
Balances, June 30, 2018	<u>\$ 1,500,000</u>	<u>\$ 5,904,709</u>	<u>\$ 84,442</u>	<u>\$ 7,489,151</u>

See Notes to Financial Statements.

COMMONWEALTH INSURANCE COMPANY, INC.

STATEMENTS OF CASH FLOWS

Years Ended June 30, 2018 and 2017

	<u>2018</u>	<u>2017</u>
Cash Flows from Operating Activities		
Cash received from premiums	\$ 950,000	\$ 950,000
Cash paid for claims and operating expenses	(623,185)	(435,654)
Investment income received	177,000	148,799
Income taxes paid	<u>(85,643)</u>	<u>(28,215)</u>
Net cash provided by operating activities	<u>418,172</u>	<u>634,930</u>
 Cash Flows from Investing Activities		
Purchase of investments	(2,896,532)	(3,688,654)
Proceeds from sale of investments	<u>2,364,015</u>	<u>2,425,080</u>
Net cash used in investing activities	<u>(532,517)</u>	<u>(1,263,574)</u>
 Net decrease in cash and cash equivalents	(114,345)	(628,644)
 Cash and cash equivalents at beginning of year	<u>496,139</u>	<u>1,124,783</u>
 Cash and cash equivalents at end of year	<u>\$ 381,794</u>	<u>\$ 496,139</u>
 Reconciliation of Net Income to Net Cash Provided by Operating Activities		
Net income	<u>\$ 637,751</u>	<u>\$ 710,754</u>
Adjustments to reconcile net income to net cash provided by operating activities:		
Realized gains on investments	(147,319)	(102,481)
Changes in assets and liabilities:		
Decrease (increase) in:		
Prepaid income taxes		12,797
Other assets	(3,946)	(4,728)
Increase (decrease) in:		
Estimated liability for future claims	(60,000)	(5,000)
Accounts payable	432	4,970
Income taxes payable	<u>(8,746)</u>	<u>18,618</u>
Total adjustments	<u>(219,579)</u>	<u>(75,824)</u>
 Net cash provided by operating activities	<u>\$ 418,172</u>	<u>\$ 634,930</u>

See Notes to Financial Statements.

COMMONWEALTH INSURANCE COMPANY, INC.

NOTES TO FINANCIAL STATEMENTS

Note 1. Nature of Business and Summary of Significant Accounting Policies

Nature of business:

Commonwealth Insurance Company, Inc., (Company) a wholly owned subsidiary of Kentucky Association of Counties Leasing Trust (COLT), provides employee dishonesty fidelity bond and business income/extra expense coverage to the members of the Kentucky Association of Counties - All Lines Fund (KALF), a related party (see Note 5).

Summary of significant accounting policies:

This summary of significant accounting policies of Commonwealth Insurance Company, Inc. is presented to assist in understanding the Company's financial statements. The financial statements are representations of the Company's management who is responsible for the integrity and objectivity of the financial statements. These accounting policies conform to accounting principles generally accepted in the United States of America and have been consistently applied in the preparation of the financial statements.

Estimates:

The preparation of financial statements in conformity with accounting principles generally accepted in the United States of America requires management to make estimates and assumptions that affect the reported amounts of assets and liabilities and disclosure of contingent assets and liabilities at the date of the financial statements and the reported amounts of revenues and expenses during the reporting period. Actual results could differ from those estimates.

Cash and cash equivalents:

For purposes of the statements of cash flows, the Company considers only cash and investments with an original maturity of three months or less to be cash and cash equivalents.

NOTES TO FINANCIAL STATEMENTS

Investments:

The Company records all investments at fair value. See Note 3 for discussion of fair value measurements.

The Company has significant investments in government securities held by Central Bank & Trust Company. Investment securities are exposed to various risks, such as interest rate, market, and credit risks. Due to the level of risk associated with certain investment securities, it is at least reasonably possible that changes in values of investment securities will occur in the near term and that such changes could materially affect the amounts reported in the balance sheet.

Revenue and recognition:

Premium revenue is recognized over the period to which the insurance coverage relates.

Legal, regulatory and geographic risk:

Legal and regulatory risk is the risk that changes in the legal or regulatory environment in which an insurer operates will occur and create additional losses or expenses not anticipated by the insurer in pricing its products. That is, regulatory initiatives designed to reduce insurer profits or new legal theories may create costs for the insurer beyond those currently recorded in the financial statements. The Company is exposed to this risk by writing all of its business in Kentucky, thus increasing its exposure to a single jurisdiction. This risk is reduced by underwriting and loss adjusting practices that identify and minimize the adverse impact of this risk.

Geographic risk is the risk that catastrophic losses will occur in one concentrated area where the Company does business. The Company mitigates this risk by adhering to specified underwriting practices.

Subsequent events:

Subsequent events have been evaluated through October 15, 2018, which is the date the financial statements were available to be issued.

NOTES TO FINANCIAL STATEMENTS

Note 2. Investments

Investments consists of marketable securities recorded at fair value and classified as “available-for-sale”. The cost and fair value at June 30, 2018 and 2017 were as follows:

	2018			
	<u>Cost</u>	Gross Unrealized <u>Losses</u>	Gross Unrealized <u>Gains</u>	Fair <u>Value</u>
U.S. Governmental securities	\$3,480,861	\$ (84,595)	\$ 842	\$3,397,108
Corporate bonds	2,181,296	(41,350)	1,650	2,141,596
Common stocks	<u>1,857,190</u>	<u>(45,436)</u>	<u>277,110</u>	<u>2,088,864</u>
Total investments	<u>\$7,519,347</u>	<u>\$(171,381)</u>	<u>\$279,602</u>	<u>\$7,627,568</u>
	2017			
	<u>Cost</u>	Gross Unrealized <u>Losses</u>	Gross Unrealized <u>Gains</u>	Fair <u>Value</u>
U.S. Governmental securities	\$3,178,779	\$(19,890)	\$ 12,518	\$3,171,407
Corporate bonds	1,989,716	(14,910)	9,990	1,984,796
Common stocks	<u>1,672,331</u>	<u>(28,388)</u>	<u>273,221</u>	<u>1,917,164</u>
Total investments	<u>\$6,840,826</u>	<u>\$(63,188)</u>	<u>\$295,729</u>	<u>\$7,073,367</u>

The aggregate annual maturities of the fair value of investments at June 30, 2018, based upon stated maturity dates are as follows:

Due within one year	\$ 446,908
Due after one year through five years	2,767,806
Due after five years through ten years	883,668
Due after ten years	1,440,322
Common stocks	<u>2,088,864</u>
	<u>\$7,627,568</u>

NOTES TO FINANCIAL STATEMENTS

Realized gains or losses are computed based on specific identification of the cost of the securities sold. Proceeds from sales of securities were \$2,364,015 and \$2,425,080 for the years ended June 30, 2018 and 2017, respectively.

Investments with declines in fair value are evaluated for other-than-temporary impairment. The evaluation includes (1) the length of time and the extent to which the fair value has been less than cost, (2) the financial condition and near-term prospects of the issuer and (3) the intent and ability of the Company to retain its investment in the issuer for a period of time sufficient to allow for any anticipated recovery in fair value. Other-than-temporary impairment of investments is reported in revenues. For the years ended June 30, 2018 and 2017, the Company did not record any other-than-temporary impairments.

The following table summarizes securities with unrealized losses at June 30, 2018 and 2017, aggregated by major security type and length of time in a continuous unrealized loss position:

	2018					
	<u>Less than 12 Months</u>		<u>12 Months or More</u>		<u>Total</u>	
	Unrealized <u>Loss</u>	Fair <u>Value</u>	Unrealized <u>Loss</u>	Fair <u>Value</u>	Unrealized <u>Loss</u>	Fair <u>Value</u>
U.S. Governmental securities	\$(31,490)	\$1,593,230	\$(53,105)	\$1,333,883	\$(84,595)	\$2,927,113
Corporate bonds	(24,299)	869,610	(17,051)	298,939	(41,350)	1,168,549
Common stocks	<u>(44,178)</u>	<u>551,537</u>	<u>(1,258)</u>	<u>45,626</u>	<u>(45,436)</u>	<u>597,163</u>
Total investments	<u>\$(99,967)</u>	<u>\$3,014,377</u>	<u>\$(71,414)</u>	<u>\$1,678,448</u>	<u>\$(171,381)</u>	<u>\$4,692,825</u>
	2017					
	<u>Less than 12 Months</u>		<u>12 Months or More</u>		<u>Total</u>	
	Unrealized <u>Loss</u>	Fair <u>Value</u>	Unrealized <u>Loss</u>	Fair <u>Value</u>	Unrealized <u>Loss</u>	Fair <u>Value</u>
U.S. Governmental securities	\$(19,890)	\$2,198,736			\$(19,890)	\$2,198,736
Corporate bonds	(3,873)	279,332	\$(11,037)	\$225,667	(14,910)	504,999
Common stocks	<u>(15,441)</u>	<u>240,514</u>	<u>(12,947)</u>	<u>164,215</u>	<u>(28,388)</u>	<u>404,729</u>
Total investments	<u>\$(39,204)</u>	<u>\$2,718,582</u>	<u>\$(23,984)</u>	<u>\$389,882</u>	<u>\$(63,188)</u>	<u>\$3,108,464</u>

NOTES TO FINANCIAL STATEMENTS

Note 3. Fair Value Measurements

The framework for measuring fair value provides a fair value hierarchy that prioritizes the inputs to valuation techniques used to measure fair value. The hierarchy gives the highest priority to unadjusted quoted prices in active markets for identical assets or liabilities (level 1) and the lowest priority to unobservable inputs (level 3). The three levels of the fair value hierarchy are described as follows:

- Level 1 – Inputs to the valuation methodology are unadjusted quoted prices for identical assets or liabilities in active markets that the Company has the ability to access.
- Level 2 – Inputs to the valuation methodology include: quoted prices for similar assets or liabilities in active or inactive markets; inputs other than quoted prices that are observable for the asset or liability; inputs that are derived principally from or corroborated by observable market data by correlation or other means. If the asset or liability has a specified (contractual) term, the level 2 input must be observable for substantially the full term of the asset or liability.
- Level 3 – Inputs to the valuation methodology are unobservable and significant to the fair value measurement.

The asset or liability's fair value measurement level within the fair value hierarchy is based on the lowest level of any input that is significant to the fair value measurement. Valuation techniques maximize the use of observable inputs and minimize the use of unobservable inputs.

All assets have been valued using a market approach. Following is a description of the valuation methodologies used for assets measured at fair value. There have been no changes in methodologies used at June 30, 2018 and 2017.

Common stocks – valued at the closing price reported on the active market on which the individual securities are traded.

Corporate bonds and U.S. Governmental securities – valued using pricing models maximizing the use of observable inputs for similar securities.

NOTES TO FINANCIAL STATEMENTS

The preceding methods described may produce a fair value calculation that may not be indicative of net realizable value or reflective of future fair values. Furthermore, although the Company believes their valuation methods are appropriate and consistent with other market participants, the use of different methodologies or assumptions to determine the fair value of certain financial instruments could result in a different fair value measurement at the reporting date.

The following table sets forth, by level, within the fair value hierarchy, the Company's assets at fair value as of June 30, 2018 and 2017:

	2018		
	<u>Level 1</u>	<u>Level 2</u>	<u>Total</u>
U.S. Governmental securities		\$3,397,108	\$3,397,108
Corporate bonds		2,141,596	2,141,596
Common stocks:			
Technology	\$ 372,460		372,460
Financial	316,951		316,951
Basic materials	221,413		221,413
Services	285,412		285,412
Industrial goods	228,131		228,131
Healthcare	187,209		187,209
Consumer goods	429,470		429,470
Energy	47,818		47,818
Total assets at fair value	<u>\$2,088,864</u>	<u>\$5,538,704</u>	<u>\$7,627,568</u>
	2017		
	<u>Level 1</u>	<u>Level 2</u>	<u>Total</u>
U.S. Governmental securities		\$3,171,407	\$3,171,407
Corporate bonds		1,984,796	1,984,796
Common stocks:			
Technology	\$ 394,827		394,827
Financial	168,534		168,534
Basic materials	207,720		207,720
Services	282,633		282,633
Industrial goods	287,790		287,790
Healthcare	210,401		210,401
Consumer goods	365,259		365,259
Total assets at fair value	<u>\$1,917,164</u>	<u>\$5,156,203</u>	<u>\$7,073,367</u>

NOTES TO FINANCIAL STATEMENTS

Note 4. Estimated Liability for Future Claims

Under Kentucky Law, the Company is required to pay all valid claims against its policyholder. The Company covers losses for employee dishonesty coverage up to a maximum of \$140,000 per event after deductibles. The Company covers losses for business income coverage up to a maximum of \$125,000 per event after deductibles. The estimated liability for future claims, net of estimated recoveries for deductibles and subrogation was determined by Company management as a result of consultation with the Company's actuary, By The Numbers Actuarial Consulting, Inc., for the years ended June 30, 2018 and 2017.

The actuary provides a range of the estimated liability for unpaid claims. Management selects an amount in that range which they believe represents a reasonable estimate of the ultimate liability. This estimate is based upon various factors such as loss control efforts, claim trends and historical claims information.

To the extent that claims information varies from management's estimates, the statement of income reflects adjustments in the year they occur.

For the years ended June 30, 2018 and 2017, the actuary provided a possible range of discounted estimated liabilities. The discounted liability selected by management was discounted at 2.0% based upon an estimate of the Company's yield on its investments and expected claims payment patterns as developed by the actuary. The loss payment pattern used could vary significantly from actual which would have a direct effect on the liability for estimated claims. The range of discounted liabilities and the amounts selected by management are as follows:

	<u>Low</u>	<u>High</u>	<u>Selected</u>
June 30, 2018	\$340,000	\$600,000	\$530,000
June 30, 2017	\$370,000	\$680,000	\$590,000

NOTES TO FINANCIAL STATEMENTS

The Company establishes a liability for both reported and unreported insured events, which includes estimates of both future payments of losses and related claim adjustment expenses. The following represents changes in those aggregate liabilities, net of recoveries, for the years ended June 30, 2018 and 2017:

	<u>2018</u>	<u>2017</u>
Unpaid claims and claim adjustment expenses at beginning of year	\$590,000	\$595,000
Incurred claims and claim adjustment expenses:		
Provision for insured events of current year and changes in provision for insured events of prior years net of recoveries	106,804	(5,000)
Payments:		
Claims and claims adjustment expenses paid attributable to insured events of current and prior years net of recoveries collected	<u>(166,804)</u>	<u> </u>
Unpaid claims and claim adjustment expenses at end of year	<u>\$530,000</u>	<u>\$590,000</u>

Note 5. Related Party Transactions

For the years ended June 30, 2018 and 2017, 100% of the Company's premium revenue was derived from Kentucky Association of Counties - All Lines Fund, which provides coverage to its members.

The Company is under a Program Administration Agreement with Kentucky Association of Counties (KACo) in which the Company reimburses KACo for certain administrative expenses. Total fees for the years ended June 30, 2018 and 2017 under this agreement were \$98,848 and \$90,165, respectively. As of June 30, 2018 and 2017, the Company had prepaid administrative fees of \$14,405 and \$22,287, respectively.

The Company is under a Management Fee Agreement with KACo in which the Company pays a fee to KACo for certain management services. The management fees for the years ended June 30, 2018 and 2017 include a base fee of \$227,500 and \$220,800, respectively, plus 3% of earned premiums collected. Total management fees for the years ended June 30, 2018 and 2017 were \$256,000 and \$249,300, respectively.

NOTES TO FINANCIAL STATEMENTS

The Company has an agreement with KACo Insurance Agency, Inc. (KIA), whereby KIA acts as the exclusive agent for the Company. The Company paid commissions to KIA of \$23,750 for each of the years ended June 30, 2018 and 2017.

The Company also has a licensing agreement with KACo that requires the Company to pay a royalty to KACo in return for the use of KACo's name and logo. The royalty for each of the years ended June 30, 2018 and 2017 was \$1,000.

Note 6. Income Taxes

For federal income tax purposes, the Company is classified as an insurance company, other than a life insurance company, as described under Internal Revenue Code Section 831(b). The Company also qualifies under Code Section 834 for an alternative income tax calculation available to certain electing small insurance companies which have net premium income not exceeding \$2,200,000. Under this election, the Company is taxed only on its net investment income. The Company is exempt from Kentucky corporate income taxes but is subject to a tax on its earned premiums collected as a captive insurer. Total federal and Kentucky tax expense for the years ended June 30, 2018 and 2017 were \$76,897 and \$59,630, respectively.

As of June 30, 2018 and 2017, the Company did not have any accrued interest or penalties related to income tax liabilities, and no interest or penalties have been charged to operations for the years then ended.

Deferred tax assets and liabilities are recognized for future tax consequences resulting from differences between the financial statement amounts and income tax bases. Deferred tax assets and liabilities are computed using enacted tax rates applicable to periods in which the temporary differences are expected to be recovered or settled. Deferred tax assets are reduced, if applicable, by a valuation allowance when it is more likely than not that some portion of the deferred tax assets will not be realized.

The Tax Cuts and Jobs Act of 2017 was signed into law on December 31, 2017. The law includes a Federal corporate rate change to a flat 21%. The Company has adopted ASU 2018-02, *Income Statement – Reporting Comprehensive Income*, and an election was not made to reclassify the income tax effects of the Act from accumulated other comprehensive income to retained earnings. Deferred tax liabilities as a result of the temporary differences due to unrealized gains on investments and a change in the corporate tax rate were \$23,000 and \$74,000 at June 30, 2018 and 2017, respectively.